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Supreme Court, U.S.
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No. 00-733

In The

Supreme Court of the United States

RICHARD NICHOLAS, et al.,

Petitioners,

v.

SAUL STONE & COMPANY, LLC, et al.,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

PETITIONERS' REPLY TO BRIEFS IN OPPOSITION

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QUESTIONS PRESENTED

In this case, the District Court for the District of New Jersey held, in relevant part, as follows: (i) that the Petitioners do not have a private remedy for violations of National Futures Association ("NFA") bylaws and rules, in particular NFA Bylaw 1101 – the NFA's "cornerstone" of self-regulation for the *protection of the public interest*; and, (ii) that the NFA may not be held liable pursuant to 7 U.S.C. §25(b)(2) unless it fails to enforce a bylaw or rule required under 7 U.S.C. §21 and determined, further, that NFA Bylaw 1101 is not such a required bylaw. The Third Circuit Court of Appeals, without specific reference or discussion, adopted the conclusions reached by the District Court with respect to each of these issues. The questions presented are:

1. Do investors in commodities futures contracts have a private cause of action against NFA Members for damages resulting from violations of NFA Bylaw 1101?

2. Is NFA Bylaw 1101 an intended requirement of the Commodity Exchange Act ("CEA")?

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SUPPLEMENTAL STATEMENT OF THE CASE

A. The Questions Presented Were Raised Below

The traditional United States Supreme Court rule precludes a grant of Certiorari only when "the question was not *pressed or passed upon below* (emphasis added). The rule operates in the disjunctive, permitting review of an issue not pressed so long as it has been passed upon. *United States v. Williams*, 504 U.S. 36, 41 (1992), citing *Stevens v. Dept. of Treasury*, 500 U.S. 1, 8 (1991). Further, this Court can exercise discretion to review an important issue expressly decided by a Federal Court. *United States v. Williams*, 504 U.S. supra, at 45 [fn. 5]. See also, *Youakim v. Miller*, 425 U.S. 231, 234 (1976).

The first Question Presented concerning a private cause of action against futures commission merchants ("FCM" or collectively "FCMs") for violations of the National Futures Association ("NFA") Bylaw 1101 was raised below as follows:

(a) *The District Court for the District of New Jersey* –

- *First Amended Complaint ("Complaint")*, Claim I, ¶ 135 (R.A.,[1] 52a), Claim II, ¶¶ 136 through 146 (R.A., 54a-57a);
- *Brief In Support Of The Motion To Dismiss*, filed by Respondents, Saul Stone & Company LLC, et al., II, A, "Count II Fails To State A Claim For Breach Of Contract, 1. No Private Cause Of Action Exists For Violation Of NFA Rules."
- *Brief In Support Of The Motion To Dismiss*, filed by Respondent, Merrill Lynch, Pierce, Fenner & Smith Inc., suggests that a claim by a third party beneficiary [customer] for breach of contract between NFA and its Member(s) is akin to a private right of

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[1] Citations to "R.A." are to the Appendix attached to Respondent, Merrill Lynch, Pierce, Fenner & Smith Inc.'s Opposition Brief.

action for violation of NFA rules.[2] POINT I, D, at pages 21 and 22 thereof.

- *Petitioners' Opposition Briefs To Motions To Dismiss,* POINT I, E, "NFA Bylaw 1101 Is Nothing More Than The Statutory Makeup Of The CEA, 7 U.S.C. §§6d, 6e, 6k and 6n And Failure To Abide By The Bylaw Is Actionable Against The FCM Defendants;" and, POINT I, B, "Plaintiffs Claim For A Private Cause Of Action For Violations Of NFA Bylaw 1101 And NFA Compliance Rule 2-30 Is Proper And Not Frivolous."

(b) *The Third Circuit Court of Appeals* –

- *Petitioners' Brief, re: Issues Presented For Review,* Issue "5. Whether Plaintiffs are allowed to bring a private cause of action for violation of NFA Bylaw 1101 (inclusive of NFA Compliance Rule 2-8(e)) and NFA Compliance Rule 2-30." POINT I, D, pages 26-33 of Petitioners' Brief.
- *Respondent, Saul Stone & Company LLC's Brief,* II, A, 1 (page 41), "No Private Cause of Action Exists For Violation Of NFA Rules."
- *Respondents', Merrill Lynch, Pierce, Fenner & Smith Inc. Brief,* POINT I, C (page 32), "No Private Right Of Action Exists For Violation Of §1101 Of The NFA By-Laws."

The District Court Opinion addresses the issue of an implied private cause of action regarding NFA Bylaw 1101, specifically at Pet. App. 69a-70a and generally at Pet. App. 63a-67a, relating to Claim II of the Complaint.

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[2] The CFTC noted at page 28 of the Order Granting [NFA] Registration And Approving Rules (1981), "Moreover, . . . , the Commission believes it is appropriate in the public interest to assess the costs of such regulation directly upon the industry and *customer beneficiaries* (emphasis added) of NFA regulation. . . . "

The Third Circuit adopted the conclusions reached by the District Court. Pet. App. 29a-30a.[3]

Notwithstanding that the *Questions Presented were raised and passed upon below*, there may always be exceptional circumstances that prompt an appellate court, where injustice might otherwise result, to consider questions of law not passed upon by the court below. *Tenneco Oil Co. v. Dept. of Energy*, 475 F. Supp. 299, 304 (1979); citing *Hormel v. Helvering*, 312 U.S. 552 (1941).

REASONS FOR GRANTING THE PETITION

(a) A conflict absolutely exists between the Second and Third Circuits regarding a private cause of action for the failure of an NFA Member to abide by NFA Bylaw 1101, see infra, at 4. Further, in the *Matter of Lake States Commodities, Inc.*, 936 F. Supp. 1461, 1469 (N.D. Il., E.D. 1996), the District Court looked to plaintiffs to offer more persuasive support for a different outcome. Pet.[4] 14-15. Indeed, the right to a private cause of action for a violation of NFA Bylaw 1101 is an important federal question because this rule is the cornerstone of the NFA's obligation to fulfill the purpose of the CEA. Reference is made to U.S. Supreme Court Rules 10(a) and 10(c).

(b) The Second Circuit's decision in *Koppel v. 4987 Corporation*, 167 F.3d 125 (2d Cir. 1999) infra, at 6, is consistent with this Court's Opinion in *J.I. Case Co. v. Borak*, 377 U.S. 426 (1964) infra, at 6, yet a departure from the decision of *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991) infra, at 6. The *Koppel* decision granted a private cause of action with reasons supporting such an outcome. Reference is made to U.S. Supreme Court Rules

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[3] The Respondent, NFA does not argue in its Opposition Brief to the Petition that the second Question Presented in the Petition was not raised below. Citations "Pet. App." Are to the Appendix attached to the Petition.

[4] The Petition is referred to herein as "Pet."

10(a), conflicting decisions, and (c), conflicting decisions with decisions of this Court.

(c) The statutory interpretation of 7 U.S.C. §§21(m) and 21(b) – in particular, the word MAY as mandatory, resulting in a *required mandatory membership rule* under 7 U.S.C. §25(b)(2). Reference is made to U.S. Supreme Court Rule 10(c), due to the inability to achieve congressional purpose of the CEA without the required rule; the Petition raises an important federal question.

ARGUMENT I:

THE SUPREME COURT SHOULD RESOLVE THE CONFLICT OVER NFA BYLAW 1101 IN FAVOR OF A PRIVATE CAUSE OF ACTION

Respondents' Briefs lead this Court to believe a conflict does not exist between the Third Circuit and the Second Circuit. In so doing, Respondents focus on *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082 (2d Cir. 1997).[5] Plaintiff in *Peltz* charged defendant, SHB, had not properly secured trading authorization under 17 C.F.R. §166.2.[6] Before accepting trades from a third party, the FCM must make a reasonable inquiry into the nature and extent of the individual's authority. *Peltz v. SHB Commodities, Inc.*, 115 F.3d 1082 supra, citing *Sansom Refining Co. v. Drexel Burnham Lambert, Inc.*, [1986-1987 Transfer Binder] Comm.

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[5] Peltz was an investor in commodities who maintained an account at SHB Commodities, Inc. ("SHB"), an FCM. Weingraten was a floor broker and was never employed by SHB. Weingarten advised an employee of SHB that he would be "doing paper" for Peltz that day. Peltz suffered substantial losses and SHB issued a margin call against Peltz' account at SHB, which Peltz could not meet.

[6] An FCM may execute trades for a customer only after the customer or someone designated by the customer to control the account "specifically authorize[s]" the trades under §§166.2(a), or provides the FCM with written authorization for the trades under 166.2(b).

Fut. L. Rep. (CCH) ¶¶ 23,796 at 34,107, 34,108 (CFTC July 20, 1987), aff'd. in part, rev'd. in part and remanded sub nom. *Drexel Burnham Lambert, Inc., v. CFTC*, 850 F.2d 742 (D.C. Cir. 1988).

In relevant part, 17 C.F.R. §166.2 includes the Third Party Account Controller rule under which the FCM must inquire as to a third party's authority to trade on behalf of a customer. Consistent with §166.2 the NFA promulgated and the Commodity Futures Trading Commission ("CFTC") approved NFA Compliance Rule 2-8(e), "Third Party Account Controller" to impose certain requirements on FCMs who carry discretionary accounts controlled by third parties. However, the FCM remains responsible for compliance with NFA Bylaw 1101.[7]

NFA Compliance Rule 2-8(e) provides an additional check in the regulatory scheme. ¶ 9001, NFA Interpretive Notices, NFA Compliance Rule(s) *2-8*, etc. (January 31, 1985).[8] According to the NFA, " . . . there are certain minimal steps which should be taken to reduce the possibility of a violation of NFA Bylaw 1101: . . . 4., which requires an NFA Member to meet the standards set forth in NFA Compliance Rule 2-8(e)." Pet. App. 149a.[9] Clearly NFA Bylaw 1101 and NFA Compliance Rule 2-8(e) *overlap*. Therefore, on February 19, 1998 the NFA approved a resolution to delete NFA Compliance Rule 2-8(e)(2). The NFA took this action because 2-8(e)(2) duplicates regulatory protections afforded by NFA Bylaw 1101.

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[7] ¶ 9001, NFA Interpretive Notices, NFA Compliance Rules 2-8, etc. (January 31, 1985).

[8] 7 U.S.C. §21(p)(3) of the Commodity Exchange Act ("CEA") *requires* (emphasis added) that NFA "establish minimum standards governing the sales practices of its members and persons associated therewith." NFA has established such minimum standard in the form of its Compliance Rules. ¶ 9001, NFA Interpretive Notices, NFA Compliance Rule(s) *2-8*, etc., (January 31, 1985).

[9] ¶ 9007, NFA Interpretive Notices, Compliance With NFA Bylaw 1101 (Staff, March 19, 1987). Pet. App. 147a.

NFA Compliance Rule 2-8(e) was approved in accordance with the substantive requirements of 17 C.F.R. §166.2. It therefore follows that *Peltz* was decided on the *same principles as NFA Bylaw 1101,* which affords customer protection inclusive of NFA Compliance Rule 2-8(e)(2) regarding the activities of a Third Party Account Controller.

The Respondents' argument that *Peltz* did not involve NFA Bylaw 1101 ignores the common and practical sense of the Second Circuit's decision as well as the NFA's determination that Rule 2-8(e)(2) is not necessary, as *its protections are covered by NFA Bylaw 1101.*

A. Investors Are Entitled To A Private Cause Of Action For Damages Resulting From Violations Of NFA Bylaw 1101

1. NFA Bylaw 1101 Is A Specific Rule For The Public's Protection

In *J.I. Case Co. v. Borak,* 377 U.S. 426, 432 (1964), this Court found an implied private right of action under SEC rules. While the statutory language makes no specific reference to a private cause of action, among its chief purposes is "the protection of investors." "Under the circumstances . . . it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose." *J.I. Case Co. v. Borak,* 377 U.S. supra, at 433; citing *Sola Electric Co. v. Jefferson Electric Co.,* 317 U.S. 173, 176 (1942).

The Second Circuit Court of Appeals in *Koppel v. 4987 Corporation,* 167 F.3d 125 (2d Cir. 1999) decided in favor of a private cause of action on similar facts and circumstances to the *Borak* case, supra, notwithstanding the earlier Supreme Court's decision of *Virginia Bankshares, Inc. v. Sandberg,* 501 U.S. 1083 (1991). The congressional intent in both *Borak* and *Koppel* "stemmed from the congressional belief that 'fair corporate suffrage is an important right . . . ', [and i]t was intended to control the conditions . . . to preventing the recurrence of abuses. . . . " 167 F.3d at 135, citing 377 U.S. at 431. Likewise, in the case at

bar the public interest is at the heart of the statutory scheme,

> "From the earliest stages of its formation, NFA's founders recognized that the creation of a meaningful and effective industry wide self-regulatory organization would be completely impossible unless all persons required to be registered . . . were required to be Members." Pet. App. 147a.

7 U.S.C. §5 renders regulation imperative to protect interstate commerce and the national public interest, while 7 U.S.C. §21(b)(1) prohibits the CFTC from registering a futures association unless it is able to find that it is in the public interest. Pet. App. 100a. See also Pet. App. 144a, NFA Articles of Incorporation, Article III, §1(a) Public Interest purpose.

Further, as noted in both *Virginia Bankshares*, 501 U.S. supra, at 1104-05, and *Koppel*, 167 F.3d supra, at 136, the judiciary looks to policy reasons for deciding where the outer limits of the implied right of action should lie. Like the SEC in those cases, the CFTC herein favors private rights of action. "Given the limited resources of the government, private rights of action are an important supplement to government enforcement actions in helping to ensure lawful conduct in the commodities industry." Pet. App. 135a.[10] Furthermore, "The right of an aggrieved person to sue a violator of the CEA is critical to protecting the public and fundamental to maintaining the credibility of the futures market." Pet. App. 183a.[11]

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[10] Where the NFA refuses to enforce its Bylaw 1101 the only recourse is to allow a private cause of action similar to judicial review of the standard of criteria set forth in ¶ 9007, NFA Interpretive Notice, *Compliance With Bylaw 1101*, as a court may do pursuant to the Administrative Procedures Act. See Pet. Argument III, page 25.

[11] The purpose of restrictions of 7 U.S.C. §25(a) is to avoid suits for speculative damages. Such is not so in the case at bar,

ARGUMENT II:

NFA BYLAW 1101 IS A REQUIRED RULE PURSUANT TO THE STATUTORY INTERPRETATION OF 7 U.S.C §21

A. Investors Are Entitled To A Private Cause Of Action Against The NFA Pursuant To 7 U.S.C. §25(b)

On January 31, 1977, the NFA organizers submitted its initial proposal of Articles of Incorporation to the CFTC, seeking registration as a §21 registered futures association ("RFA").[12] The Articles of Incorporation, §III,(1)(g)[13] specify one of the two purposes of the NFA to be "[t]o prohibit any member from carrying accounts or from handling transactions in commodity futures contracts or commodity options on behalf of a non-member acting in respect to such accounts or transactions as a FCM, CPO, ..." This was the required provision for eventual NFA approval as an RFA and makes NFA membership mandatory. Approved as Article III, §(1)(f).

A thorough review of 7 U.S.C. §21, without §21(m), causes one to conclude, as did the Department of Justice in 1977, that the statutory intent, in particular subsections (b)(2), (d) and (e), was to make membership in an RFA

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which is the result of transactions on the market. Futures Trading Act of 1982, Pub. L. 97-444; House Report No. 97-565, Part I, pages 56-57. Pet. App. 184a. See also *Koppel*, 167 F.3d supra, at 137. In a number of instances, the basis for disallowing a private right of action was due to the speculative nature of non-trader issues (see *American Agriculture Movement v. Bd. of Trade*, 977 F.2d 1147 (7th Cir. 1992)) and membership disputes (see *Cardoza v. CFTC*, 678 F.2d 1542 (7th Cir. 1985)), both of which do not come within the remedial intent of the CEA.

[12] Comments of the U.S. Department of Justice were issued on October 7, 1977 In The Matter Of The National Futures Association ("October 7, 1977 Application").

[13] October 7, 1977 Application, page 26.

voluntary, not mandatory. The Department of Justice determined that for the CFTC to then find scope for compulsory membership in §21 is to simply engage in legislation on its own. October 7, 1977 Application, page 43. The aforesaid was the compelling reason for the enactment of 7 U.S.C §21(m), thereby settling the question whether the CFTC has the authority to register an RFA, requiring mandatory membership, in addition to achieving the least anti-competitive means for compulsory membership.[14]

In either case, Congress determined it was necessary and an RFA would not have been approved by the CFTC without a rule requiring membership. For without such a requirement the RFA would not appear capable of fulfilling the CEA's purposes, "that such association is in the public interest." 7 U.S.C. §21(b)(1). Therefore, 7 U.S.C. §21 was amended to allow for compulsory membership.

The NFA is the first and only RFA. As part of its initial registration approval and for all times thereafter, "[T]he founders of NFA considered the issue to be of such critical importance that they not only prohibited the conduct of customer business with non-Members through NFA Bylaw 1101, but included that prohibition as one of NFA's fundamental purposes in Article III, Section 1(f) of NFA's Articles of Incorporation." Pet. App. 147a.

NFA's compulsory membership has rendered the language of 7 U.S.C. §21(b)(2), whereby any person eligible for membership *may* become a member of the RFA (Pet.

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[14] Such is the statement of purpose in order to provide mandatory membership in RFA in order to achieve the regulatory scheme and protect the public interest. Pet. App. 111a. By enacting §21(m), Congress took note that:

> "This objective [of effective self-regulation] would be frustrated if futures industry professionals were free to discontinue their membership, . . . , when their own acts and practices came under scrutiny or investigation . . . ." S. Rep. No. 650, 95th Cong., 2d Session 31 (1978) at Pet. App. 112a.

App. 155a), ineffective. Therefore, the only logical reading of the CEA is to interpret MAY in §21(b) and in §21(m) as SHALL. In fact, every requirement under 7 U.S.C. §21(b) 1-13 inclusive, *derives its meaning from required membership in an RFA*. As such, §21 cannot survive without 7 U.S.C. §21(m)[15] and, thus, NFA Bylaw 1101 must be deemed *a required Bylaw*. To do otherwise would not give meaning to all provisions.

The basic tenet of statutory construction applies equally to the interpretation of regulations, i.e., 17 C.F.R. §166.2 [and rules, NFA Bylaw 1101]. The preferred statutory and regulatory construction is one that gives meaning to all provisions. Unless the word MAY in §21(b)(2) is read as SHALL a conflict will exist between this statute and NFA Bylaw 1101. *Idahoan Fresh v. Advantage Produce, Inc.*, 157 F.3d 197, 202 (3d Cir. 1998). "Where a literal rendering [of a statute] will lead to a result not in accord with [its] essential purpose and design . . . , the spirit of the law will control the letter." *State (N.J.) v. Ercolano*, A-6729-98T3 (N.J. Super., App. Div. 11/28/00).

CONCLUSION

For the reasons set forth hereinabove and in addition to the Petition, Petitioners respectfully request that the Petition for Writ of Certiorari be granted.

Respectfully submitted,

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[15] Requiring membership in an RFA is an essential factor in providing the effective, industry-wide customer protection that the NFA proposes. If membership were purely voluntary, those engaging in abusive practices could evade self-regulatory compliance. Pet. App. 114a.